The Law of Unintended Consequences

Rules have consequences. And sometimes they have unintended consequences. If I told you that the US government was going to give multiple tens of billions of taxpayer dollars to hedge funds and private investors, you would justifiably not be happy. I think the word angry would come to mind. But that is exactly what is happening, as a result of rules that were written for a time and place seemingly long ago and far, far away. Further, we are looking at potentially much larger sums being lost in the bank bailout (can we say hundreds of billions?), a reduced lending capacity at banks and, in general, a worsening of the very problems at the core of the crisis.

The good news is that it can be fixed, but the authorities need to get a sense of urgency. As Steve Forbes writes today in the Wall Street Journal, Obama is continuing with the worst of Bush’s policies, making the crisis far worse than it should be. It is as if we are giving all 13-year-old kids a “F” in math because one kid failed.

Today’s letter will look at some rather obscure rules which are having major unintended (and negative!) consequences, and what can be done. Then, if we have enough time, we will look quickly at Japan, unemployment, and a few more statistical predictions of when the recession will end that you should be very wary of. It’s a lot to cover, but it should make for an interesting letter.

But first, and quickly, I just wanted to take a moment and remind you to sign up for the Richard Russell Tribute Dinner, all set for Saturday, April 4 at the Manchester Grand Hyatt in San Diego – if you haven't already. This is sure to be an extraordinary evening honoring a great friend and associate of mine, and yours as well. I do hope that you can join us for a night of memories, laughs, and good fun with fellow admirers and long-time readers of Richard's Dow Theory Letter.

A significant number of my fellow writers and publishers have committed to attend. It is going to be an investment-writer, Richard-reader, star-studded event. If you are a fellow writer, you should make plans to attend or send me a note that I can put in a tribute book we are preparing for Richard. And feel free to mention this event in your letter as well. We want to make this night a special event for Richard and his family of readers and friends. So, if you haven't, go ahead and log on to https://www.johnmauldin.com/russell-tribute.html and sign up today. The room will be full, so don’t procrastinate. I wouldn't want any of you to miss out on this tribute. I look forward to sharing the evening with all of you.

I am looking for a few sponsors to help with the costs, to make sure we do this evening right. A number of friends, along with EverBank (www.everbank.com) and
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ProFunds (http://www.profunds.com/), have already committed. Drop me a note if you would like to be a sponsor as well. And now to a discussion of the rules.

Unintended Consequences

(Let me state at the outset that I am going to oversimplify this story to keep it from getting too long and technical, because I think it will make it far more readable and understandable to the majority of readers.)

Let me note that while I am talking about rules that do not make sense, this in no way should be seen as a criticism of the regulators. It is their job to enforce the rules, not make them. The authorities at the top (including Congress and the administration) should be taking action.

In the beginning there were ratings agencies, and they rated corporate bonds from the very highest of credit quality (AAA) down to junk (CCC).

Now AAA means that the chances of losing money are very, very low. With each level of increased incremental risk comes a lower rating. If a corporate bond was at risk for losing just one dollar, it was rated all the way down to junk. And that was fine. Everybody knew the rules of the game.

But then investment banks asked the agencies to rate a large group of home mortgages in a pool known as a Residential Mortgage Backed Security (RMBS). The investment bank would divide the pool (the RMBS) into various tranches. The highest-rated tranche would be given a rating of AAA. Let’s say that the AAA tranche was 92% of the loan pool. The AAA tranche would get the first 92% of all monies coming into the pool before the other investors were paid (again, really oversimplified, but that is the net effect). That would mean that the pool could have 16% of the home loans default and lose 50% of their value before the AAA tranche would lose even one dollar.

We all know now, though, that some of those AAA-rated tranches are in fact going to lose money. And the rating agencies are now writing down the ratings on the former AAA tranches.

I am not talking about the exotic CDOs and CDO squareds, or some of the truly toxic securitized assets which are going to zero. What I am writing about today are plain vanilla mortgages grouped together in securitized pools.

I wrote three weeks ago, “The downgrades by Moody's today of 2,446 different classes of Residential Mortgage Backed Securities will be a real blow. Moody's warned in a report last week that loss assumptions would be increased for RMBS and that downgrades could be expected. Moody's is projecting that alt-A deals originated in the second half of 2007 will experience 25.5% losses of original balance, compared to 23.9% of 1H07 deals, 22.1% for H206 deals, and 17.1% for 1H06 deals. The rating agency in
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May expected average losses for 2006 and 2007 vintage deals to reach 11.2% and 14.7%, respectively.” (The Big Picture)

Fitch and S&P are also piling on with downgrades. Most of them see RMBS’s go from AAA all the way down to junk. This has some very bad unintended consequences.

Let’s say a bank has a loan portfolio of 1,000 individual mortgages valued at an average $200,000, for a total portfolio value of $200 million. The loan officers were not very good, and it turns out that 18% of the homes went into foreclosure and lost an average of 50%. That means 180 homes went into foreclosure and that the bank lost an average of $100,000 per home, or $18 million overall. The bank was charging 6% interest, so in a few years it would at least have its original investment back, although the losses would eat into capital.

To make those loans of $200 million, the bank would need at least $20 million in capital, and so would need to go raise some money or reduce its loan portfolio by selling the performing loans. The reality is that for a bank to have such a large mortgage book, it would probably be a much larger and better-capitalized bank. If it were not, it would soon be taken over by the FDIC.

Note that the remaining 82% of loans are still performing and are carried on the books at full value (again, oversimplified). There is real value in the remaining loan portfolio.

But what if the bank invested in a RMBS that was rated AAA, and 18% of the loans in the security went bad? Remember, the AAA tranche gets the first 92% of income. The loss to the RMBS is 9% of capital. The losses to the AAA tranche are only 1%. Hardly a catastrophe. Annoying, but something you can deal with. Except for some very nasty rules.

Remember, a bond is downgraded to junk if it loses even $1. Now, let’s take it to the real world.

Say a bank buys a $1-million AAA portion of that large RMBS. It can use that AAA debt in its capital base, and can actually lever it up about five times, as the rules only make the bank take a 20% “haircut” on an AAA bond. But if the bond goes to CCC, the bank must now move the entire bond to its “risk-impaired” portfolio. And because most institutions cannot buy junk paper, there are very few buyers out there who will want to buy it – mostly hedge funds and private capital. The price on that paper might easily drop to $.50 on the dollar because of the potential for a 1% loss.

The accountants, being conservative and living with new mark-to-market rules, make the bank take a $500,000 loss. This directly reduces regulatory capital by $500,000. Banks are required to have a maximum of 8% of risk-impaired assets as compared to solid capital to be considered adequately capitalized. Keeping the asset on the books
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means they have $1 million of risk-weighted assets. If they have to sell to get the capital required to follow the regulations, they will lose $500,000.

And they lose this on an asset that the rating agencies say might lose $1 ten years from now.

Again, at the risk of oversimplification, if they keep the security that also means that the bank loses roughly $10 million in lending capacity. They have to reduce their loan book or raise more capital.

Rating Agencies Gone Wild

Here’s the truth. That bond should never have been rated AAA to begin with, and it shouldn’t be rated CCC today. The ratings agencies took a perfectly fine corporate bond rating system and tried to bootleg it onto a security that has an entirely different set of circumstances. A corporate bond is a bond from one company or one obligor. An RMBS might have several thousand obligors. (An obligor is a person or entity that is obligated to pay back debt.)

It was very convenient for investment banks to get the rating agencies to use the corporate bond analogies, because that meant they did not have to explain a new system. Everyone knew what AAA meant, or AA or BBB. A bond buyer in Europe or at a pension fund simply looked at the rating and hit the buy button. Easy. No need for a lot of research. Make your purchases and go to lunch.

While I can’t go into specifics, I have looked into these bonds with some real interest. Let’s assume that you can actually buy an AAA tranche of an RMBS at $.60 on the dollar. That means that 80% of the mortgages would have to go into foreclosure and lose 50% before you would ever lose a penny.

There are AAA bonds selling at steep discounts that are composed of mortgages with 80% loan-to-value in 2005, a 7% interest rate, and 90+ percent performing loans. These loans are being called in as mortgagees take advantage of lower rates and refinance. And with Obama’s new proposed lower rates, even more of these loans will be refinanced. If you buy the loan at $.60 on the dollar, and it gets refinanced, you get an immediate capital gain of almost 50%! If it keeps on being paid, you get an effective rate of about 10%.

So, why wouldn’t there be a lot of institutions standing in line to buy such a dream investment? Because banks fear the danger that the security will get downgraded, just like the thousands of such instruments that have already been downgraded, and then their regulatory capital will be impaired. The technical banking term is that you would be screwed. So you don’t buy what would be a very good performing asset, because of the rules.
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So, who can (and does!) buy? Hedge funds and private investors with liquidity. But these “vulture capitalists” (among whom are many of my friends) know that the sellers are operating from a position of weakness. And because there are not enough of them to buy the bonds on offer, the prices of these bonds are very low. Smart money managers are raising money to exploit these distressed sellers.

So, in effect, we are giving banks taxpayer money while forcing them to sell assets that might be worth $.95 cents on the dollar in a less-stressed world. We are shoveling money in the front door while it is being pushed out the back door to my friends at the hedge funds.

How much are we talking about? US banks and thrifts have $315 billion in AAA non-agency (Fannie and Freddie) bonds, insurance companies have $190 billion, broker dealers have $75 billion. Overseas investors have $160 billion. Banks have written down about $700 billion in assets. The majority of those losses have been mark-to-market write-downs and not actual losses. Yet taxpayers are in essence paying them to sell, because the rules say they have to raise capital.

Some simple rules changes would solve a lot of this problem. First, let’s recognize that the root of this particular problem is the ratings system. If an RMBS is likely to get $.95 of its capital, then it should be valued at some number below that, but don’t make them assign it 100% to their risk capital. That is like making the bank with the 1,000 home loans in its portfolio write off all of them because 18% are bad. In principle, there should be no difference.

Then, the Federal Reserve should call in the rating agencies and have a “come to Jesus” meeting. They are at the heart of the problem, and they need to fix it. They need to change their ratings system for packaged securities like RMBS’s.

The I-Factor

Let me throw out one idea (there are likely to be a lot better ones, but let’s get some ideas on the table). Let’s move away from using standard bond ratings for multi-obligor securities. Why not rate a bond by the percentage of capital likely to be returned? Let’s call it the Impairment Factor, or I-Factor. If a bond is likely to lose 10% of its capital, then it would have an I-Factor of 10%. An I-Factor of 0% would mean the bond should see all its capital returned, and an I-Factor of 100% would mean that all the money will be lost.

Now, that tells investors something. That’s a useful statistic, as opposed to “CCC.” What does CCC mean? Am I going to lose $1 or $1,000 or all my money? CCC gives me no useful information if I want to buy or sell a bond. And without real transparency, you end up with a world in which a few very knowledgeable buyers can make a lot of money.
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That is because there are a lot of AAA bonds that are going to zero, as in 100% loss. If you are on an institutional desk and would like to participate in getting some of the better values, unless you have a very sophisticated team with good analysis software, you simply can’t take the risk.

Further, if the rating agencies do their homework to figure out what the I-Factor is, they will have all sorts of useful information that can be disclosed about the security, such as average loan balance, average loan-to-value, how many loans are at risk of default, where the loans are, and scores of other details. Armed with that information, buyers can make rational decisions.

And if you modify the rules so that banks and other institutions can use those bonds (with an appropriate haircut) as part of their regulatory capital, then you immediately get a large number of buyers into the market, and that will make prices go up and mean that banks will need less taxpayer money.

The current rules were written for a time when banks actually bought corporate bonds. They made sense back then, and still do. But applying those ratings to asset-backed securities makes no sense. We need to change those rules now.

Marking assets to market when there are no markets is illogical. I have spent some time looking at these securities. Like kids, they are all different. And some are really different. Yet we make a bank mark an asset down because one that is in the same broad class is impaired. Like giving every 13-year-old in school an “F” in math because one kid failed.

Further, we don’t make a bank mark down the value of a loan on its books if interest rates increase. The loan, if sold into a market, would indeed not be sold for book value. But the bank keeps it at book value on its books, and simply realizes less interest. If we made banks mark down their assets because of interest-rate increases, we would lurch from one bank crisis to another with every interest-rate cycle.

Let me be clear. I am for full transparency. If an asset is only worth ten cents on the dollar, then mark it down. We do not need zombie banks. For whatever reason, the Obama administration seems to be afraid to use the “N” word (nationalization). If a bank is insolvent, yet deemed too big to fail, then take it over, repackage it, and sell it back to the private market with some options that will allow for taxpayers to at least have the potential to get their money back. But do it quickly rather than dithering, as is happening now, because that will just cost more in the long run.

But as a start, change the accounting rules so that we stop shoveling taxpayer money in the front door to banks and out the back door to hedge funds. That can be done quickly if the administration simply says “do it.”

Let me quote this note from Gary Townsend, which I wholeheartedly agree with:
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“The problem, of course, is that the MTM (mark-to-market) results have little to do with the intrinsic value to a bank of a loan or a security that it plans to hold to maturity. In a bank, the decline in a loan’s value is offset with a forward-looking provision for loan losses. The decline in the loan prices net of loan loss allowances is not due to credit deterioration; it’s the result of the distortions and speculation in the world’s financial markets. Mark-to-market accounting isn’t improving the transparency of bank accounting. It has reduced it, with enormous and growing damage to our economy and prospects.

“The Financial Accounting Standards Board has said that it will issue new guidance on the application of FAS 157. That’s encouraging, but can anyone recall when the FASB has been timely? The damage from this misguided rule is already huge, widespread, and growing daily. Mark-to-market accounting creates a powerful negative feedback loop. Actual or imputed FAS 157-related losses weaken capital ratios and undermine confidence in the financial system generally, which weakens the economy and adds pressure on loan pricing, causing more FAS 157 losses, and around we go.

“This cycle needs to be broken. Mary Schapiro? Tim Geithner? Are you listening?”

And let’s add President Obama, Ben Bernanke, Barney Frank, Chris Dodd, and Larry Summers to the list of those who should be listening. I know that some of my readers will have access to these people. See if you can get them to focus on this problem, and let’s move on to the next problem – housing.

As a final note, I know that some regulatory bodies are in fact paying attention to this while others are not. Good on the ones who are listening. As for the others, the adults in charge need to make sure the kids are playing nicely in the sandbox. This is an argument for a significant review and reform of our regulatory system. But right now, we need some immediate action.

Knights to the Rescue

The world is in the throes of a global recession. But as usual, the very poorest are being hurt the most. I want to close by quickly asking you to consider helping one of my favorite causes, emergency relief for the poorest of the poor. My friends at Knightsbridge (Ed Artis, et al.) currently have three hundred thousand dollars of medical equipment and supplies (relief) sitting in two separate locations here in the United States. It’s worthless while stored here but "gold" in the developing world. We need $37,000 to ship these items to the Philippines, where we can stage them for delivery to clinics in Cambodia, Vietnam, Myanmar, and the Philippines. This medical relief, when delivered, will save the lives of thousands of people affected by disease and poverty.

Knightsbridge works with many people around the world who volunteer their time to help us hand-deliver this relief, as you can see in Adrian Belic’s multi-award-
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winning documentary film Beyond The Call (http://www.beyonddthecallthemovie.com/) and (http://www.pbs.org/independentlens/beyonddthecall/).

For every additional $18,500 that is raised, we can obtain and ship 40 cargo containers of valuable medical supplies and equipment, worth between $150,000 and $500,000, to the staging area in the Philippines.

We have almost unlimited resources here in America for the collection and staging of medical equipment and supplies to be shipped overseas. We will run out of shipping dollars long before we ever run out of medical relief goods in need of shipping.

Each dollar that you donate will ship many times that much in lifesaving medical relief. Your donations can be sent to Knightsbridge in two ways:

* Online donations are immediate and can be sent to us via the PayPal / DONATION icon located on our website at www.kbi.org
* Checks should be made out to our NEW partner NGO, A Prescription for Peace, in the US (http://www.APrescriptionForPeace.org).

These checks will be processed, appropriate receipts issued, and the proceeds deposited to our credit.

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